Jean-Claude Trichet: The great financial crisis – lessons for financial stability and monetary policy

Introductory remarks by Mr Jean-Claude Trichet, President of the European Central Bank, at the Colloquium in honour of Mr Lucas Papademos, Vice-President of the European Central Bank, Frankfurt am Main, 20 May 2010.

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Ladies and gentlemen,

Introduction

The subject of this colloquium – "the great financial crisis"– could be no other since Lucas Papademos' tenure will be remembered for the immense challenges for financial stability and monetary policy that have arisen since the trigger of the subprime crisis in 2007.

Lucas played a key role at both the global and European levels in tackling these challenges. He was among those who were prescient about the considerable build-up of risks in the years before the crisis. He placed significant efforts in developing and adapting financial stability analysis to the fundamental and far-reaching changes in the financial system we have witnessed in the past decade, particularly as a result of increasing financial integration and innovation. When the crisis unfolded, Lucas was one of the foremost policy-makers in devising the actions required to stabilise the financial system. He also played a substantial part in setting the ground for regulatory reform, namely through his participation in the Financial Stability Forum, later Board, and in several European and Eurosystem fora, a number of which he chaired himself.

I am therefore delighted that we were able to organise this colloquium with such a set of distinguished speakers, all of which have their exceptional professional standing deeply associated with the financial crisis, either as policy-makers, crisis managers, academics or proponents of regulatory initiatives.

My introductory remarks this afternoon are organised around the title of this colloquium. My aim is to review policies in the last few years and draw some policy conclusions. I will first touch upon some of the lessons for financial stability, where Lucas's contribution was especially important, as responsible for the financial stability function, and then turn to the experience with monetary policy.

Lessons for financial stability

The financial crisis erupted in August 2007, when off-balance sheet vehicles that had been set up by banks to manage portfolios of complex structured credit securities ran into funding liquidity problems. Although initially a liquidity squeeze, concerns about counterparty credit risks quickly spread as uncertainties intensified about the nature and extent of exposures of banks to what we now call "toxic assets". And, as we know, these escalating tensions culminated in the bankruptcy of Lehman Brothers in September 2008, an event which triggered an unprecedented surge of volatility across mature-economy financial markets and a broad-based decline of asset prices. With this, an adverse feedback between the condition of the financial system and real economic performance was unleashed, contributing to a sharp economic slowdown across the developed economies. Now we are observing renewed tensions, as the costs of supporting financial sectors, fiscal stimulus and automatic stabilisers brought the focus to public finances across many countries both within and outside the euro area.

With hindsight, the financial crisis has reminded us that the seeds of financial instability are often the same: balance sheet mismatches, high leverage (on or off balance sheets) and very rapid growth of financial institutions. Essentially all of these elements were at play in one form or another in this episode. Now what are the lessons for financial stability monitoring and assessment frameworks as implemented by the responsible authorities?

A first observation I would like to make in this respect is, that we, as other central banks, had been drawing attention in our semi-annual Financial Stability Review, which Lucas was overseeing for many years, to the risks that were building up. For at least two years before the turmoil began, we issued clear warnings about vulnerabilities that were building up on account of an increasingly aggressive hunt for yield which was underpinning significant under-pricing of risks across a variety of asset classes, not only credit derivatives. And, I should also say that, the same warnings were communicated by several other central banks. A second observation is that in parallel with our financial stability assessments, we also repeatedly warned euro area governments of the risks of not consolidating fiscal positions in accordance with the rules of the Stability and Growth Pact.

Although in many respects the crisis that unfolded in 2007 and 2008 can be seen as the direct result of vulnerabilities and imbalances which had been growing steadily and which had been identified fairly early-on, they combined in such ways that few would have anticipated their potential severity for the functioning of the financial system. This notwithstanding, we and other major central banks reacted swiftly to mitigate the stresses in the functioning of money and other affected markets.

Against this background, to build a safer financial system it is of paramount importance that the responsible authorities enhance their financial sector surveillance while at the same time financial institutions play a decisive role by enhancing their risk management practices. A key challenge for policy-makers will be to design appropriate responses to enhance the stability of the financial system – including improving the detection and understanding of risks and vulnerabilities and translating these into concrete risk warnings and policy recommendations – without imposing restrictions that would unnecessarily hamper financial innovation and reduce the efficiency of the system. Many improvements, including the new Basel II Capital Accord, were already under way when the crisis erupted, and they address several of the weaknesses that have been identified. However, the ferocity of the financial turmoil and its fall-out which spread well beyond the financial sector call for more far-reaching reforms in the area of macro-prudential supervision.

In this context, a key initiative is the proposal for the establishment of a European Systemic Risk Board (ESRB), which will be supported analytically and logistically by the ECB and for which Lucas has already initiated a lot of groundwork.

The ESRB will be an independent body responsible for conducting macro-prudential oversight of the EU's financial system as a whole. Once the legislative process is completed, the creation of this new European policy function will fill a significant gap in the ability to detect, assess and ultimately contain the build-up of risks. In particular, the ESRB will be tasked to collect information relevant for systemic risk from across the EU. This should help overcome the significant information gaps which have hindered a comprehensive risk surveillance thus far, for instance with regard to the interlinkages among the major cross-border financial institutions.

The ESRB should be seen as the component of a global framework of macro-prudential oversight. This should support its effectiveness by also allowing it to contribute to the assessment and containment of global risks, which in turn may also contribute to the mitigation of risks in Europe. The Financial Stability Board, the IMF, as well as national authorities, are all actively engaged in the development of a comprehensive framework of macro-prudential supervision, which also takes into account the risks arising from systemically important financial institutions. The crisis demonstrated that only internationally coordinated initiatives are truly effective in addressing risks and vulnerabilities in the closely integrated financial system.

Lessons for monetary policy

With regard to monetary policy, in many respects recent events have served to confirm the approach adopted by the ECB since the outset of Monetary Union in 1999. Most fundamentally, the primacy of price stability as the objective of monetary policy has been confirmed. Indeed, at times of financial stress, the credible maintenance of price stability becomes even more important. Were the anchoring of inflation expectations to weaken, financial market tensions would intensify further and corrective measures would prove less effective. Moreover, our recent experience of financial crisis – with its roots in the evolution of bank balance sheets, and thus monetary and credit developments – has vindicated in my view the importance attached by the Governing Council to a close and regular monitoring of the monetary data.

In the design of the ECB's monetary policy strategy, it was always foreseen that the close monitoring of monetary developments would provide a framework for policy makers to consider asset price developments and potential misalignments. Responding to monetary and credit dynamics as part of a comprehensive assessment of the risks to price stability in the medium term implies that interest rate decisions will tend to "lean against" accumulating financial imbalances and asset price misalignments. Recent research provides a vastly enriched framework for conducting such monitoring in a systematic fashion, and offers a real possibility that asset price disequilibria and associated financial distress may be identified at an early enough stage for corrective measures to be taken by the policy authorities. Further development of this framework promises to support financial and macroeconomic stability, within an overall strategy focused on achievement of our primary objective: price stability.

Such considerations, in concert with the development of a new framework for macro-prudential oversight, should permit to reduce the frequency, duration and economic impact of financial crises. These are themes that will be discussed in depth in the course of today's colloquium. We have to make sure that the global financial system, as well as continental and national ones, are made much more resilient. Yet, it would be unrealistic to believe that financial crises can be eliminated. Recent experience has also demonstrated the need for central banks to be timely and agile in managing financial crises without ever – in any circumstances – losing their sense of the medium to long-term orientation to price stability.

As regards the ECB, in the face of financial crisis, monetary policy was eased significantly through conventional means in late 2008 and early 2009, with key interest rates being reduced significantly.

Moreover, non-standard measures, in the form of the ECB's enhanced credit support were introduced. These aimed at maintaining an efficient transmission of monetary policy by supporting market functioning. Such measures were instrumental in the maintenance of price stability, since, in the face of downside risks to price stability, they ensured that the easing of the monetary policy stance was transmitted into a broader easing of financing conditions. In particular, the ECB expanded scope for central bank intermediation of transactions between banks, thereby offering an alternative to the malfunctioning private inter-bank money market. At the same time, the measures supported financial stability objectives by containing and mitigating the systemic consequences of liquidity tensions in the money market.

To conclude, let me say a few words on the recent decisions of the Governing Council taken on 9 May and announced on 10 May. As I already said publicly, I will sum up in five points the Governing Council's position.

1. The ECB is fiercely independent and takes all its decisions independently of governments, social partners and pressure groups of any nature.

2. We are inflexibly attached to price stability, our primary mandate. Our successful track record since the inception of the euro is remarkable.

3. Our present monetary policy stance is appropriate. Our decisions taken on 9 May have confirmed it. We are not engaging in any form of "quantitative easing".

4. The "Securities Markets Programme" is designed to ensure an effective functioning of the monetary policy transmission mechanism by helping to resolve a malfunctioning of some segments of the euro area debt securities markets.

5. The liquidity provided through this programme is withdrawn in its entirety through tenders of term deposits.

Conclusion

I would like to end my remarks by acknowledging the outstanding contribution that Lucas has made to the conduct of monetary policy and the safeguarding of financial stability in these demanding and historic times, as I have just described. I cannot stress enough the important role he has played at the ECB, as well as in Europe and globally, to successfully ensure the sound pursuance of these essential policies, ultimately for the benefit and well-being of the societies and citizens which we serve. We are all very grateful to Lucas.